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Financial sector FDI in Asia: *Brief Overview*[1]

A note for the meeting of the CGFS Working Group on FDI in the Financial Sector

Introduction

Asian markets continue to be major destinations of international capital flows, both in terms of securities investment and foreign direct investments (FDI). While the share of international capital flows to Asia has declined somewhat since the Asian Crisis, currently more than 40% of total capital flows to emerging markets is estimated to be directed towards Asian markets.

This note gives a brief overview of the facts and noteworthy features of FDI in the financial sector in Asia, including comparisons with other regions and observations from the Asian Crisis. It draws heavily from the discussion among WG members in the Asia-Pacific region, as well as individual studies by the respective members. As such, interested readers are encouraged to refer to the papers submitted to the WG for more details.

Asia as a destination of financial sector FDI

FDI in the financial sector in Asian markets have grown considerably over the last decade. While no definitive statistics exist, data from Thomson Financial show cross-border mergers and acquisitions (M&A) towards the financial sector in Asia totaled $23 billion during the last five years, its yearly average being roughly 11 times as large as the first half of the 1990s. However, the overall amount and growth are much smaller than in Latin America, where respective data show a total of $41 billion and average annual flows about 40 times as large in the corresponding period.

One of the features that differentiates Asia from other emerging market economies is the limited degree of foreign participation in the domestic banking sector. In absolute terms, foreign banks' assets in East Asia (ex-Japan), at about $600 billion, are far larger than the $400 billion for Latin America or the $150 billion for Eastern Europe. In relative share terms, however, the share of foreign bank assets in Asia, at about 10 percent, is far smaller than 33 percent in Latin America and over 50 percent in Eastern Europe. In Latin America and Eastern Europe, a series of "mega" takeovers have led to a significant foreign bank presence in many countries, frequently with a large portion of the banking system owned by foreign institutions. The average size of cross-border financial sector M&A deals during the last five years was around $40 million in Asia, considerably smaller than that of around $187 million in Latin America. This mostly reflects the

[1] This note was prepared by Isao Hishikawa (Bank of Japan), based on inputs and comments from WG members from the Reserve Bank of Australia, Bank of Japan and Monetary Authority of Singapore.

fact that in Asia, many takeovers were either purchases of small financial institutions or acquisitions of minority stakes, with the exception of Thailand.

Such differences appear to be partly due to the regulatory hurdles against foreign entries, and partly due to the difference in the historical path towards economic development. Many countries still have some restrictions against foreign bank entry. Singapore and Hong Kong have a larger foreign bank presence because of their British colonial history, open offshore banking centers, and the large foreign presence in their financial markets. Southeast Asia has a relatively large foreign bank presence compared with Northeast Asia as foreign corporations played an important role in their industrialization and their export-led growth strategy. In many of these Southeast Asian countries, foreign financial institutions frequently expanded through branches as opposed to subsidiaries, pursuing a “follow the client” strategy, and have been less active in lending to local businesses. However, the Asian Crisis and competition for more FDI has led to a significant relaxation or removal of these restrictions against foreign bank entry and expansion in the second half of the 1990s across several Southeast and Northeast Asian economies. These include Indonesia, Korea, Thailand, the Philippines and Taiwan.

China is a special case. It still has a very small foreign bank presence, but with China’s entry into the WTO, obstacles to foreign bank participation are scheduled to be loosened significantly in the coming years. According to some estimates, currently some 80% of direct investments towards Asia are in China, though most of them are in the non-financial sector. Further liberalization of foreign bank entry has a potential to change dramatically the overall picture of financial sector FDI in Asia.

Observations from the Asian Crisis

It appears that the severity of the Asian Crisis during 1997-1998 had more to do with capital account liberalization and fragile domestic banking system, than banking sector liberalization, per se. Thailand and Indonesia had relatively low foreign bank presence but both countries were hit the hardest. On the other hand, there is some evidence, although not conclusive, that foreign bank presence helped to stabilize the banking system. For example, foreign branches were able to fund their lending activity because of the increased funding from their head offices and their ability to increase net borrowing from the interbank market, especially in Thailand and Singapore. The non-performing loans (NPL) ratio for the foreign banks was also far smaller than those of the local and state-owned banks.

The Asian Crisis was a watershed event as far as financial sector FDI is concerned. Since the crisis, foreign bank participation has risen strongly in terms of the share of banking assets, especially in Thailand and Indonesia. The rise in foreign bank participation is primarily due to a) the liberalization of foreign investment restrictions and acquisition by foreign banks, b) the sharp fall in the number of local banks, and c) the large write-off of local banks' non-performing assets.

The Asian Crisis also appears to have been a catalyst for a number of changes in the composition and characteristics of bank lending. For instance, while both domestic banks and locally based foreign banks sharply reduced their lending at the time of the crisis, since then growth in bank lending has been mainly accounted for by increased lending on the part of local banks and locally based foreign banks in local currency. In some countries such as Malaysia and Thailand, growth in lending by foreign banks based locally and in local currency has exceeded those of local banks. During the years shortly preceding the crisis, lending by foreign banks based locally and cross-border lending showed high growth. Moreover, the maturity profile of cross-border lending has lengthened and the proportion of lending by domestic banks denominated in local currency has risen.

One of the features that distinguished the Asian Crisis from other emerging market crises was the extent of NPL. These increased sharply in 1998, and in Thailand almost reached the equivalent of 50 per cent of total loans. Financial sector liberalization and pressures on bank profitability provoked debate on a wide-ranging set of issues, including the design of deposit insurance systems, the provision of basic banking services, corporate governance, and the role for international coordination among bank regulators. Indeed, the crisis was a catalyst for many reforms designed to strengthen institutional and governance arrangements and improve financial market efficiency, though the benefits of these changes are difficult to quantify.

Asia as a source of financial sector FDI

Another change in the Asian banking sector since the financial crisis is the rising foreign direct investment of non-Japan Asian banks. Prior to the mid-1990s, Japanese banks were the traditional source of lending to and investment in East Asia's financial sector. Other countries in the region including Australia traditionally favored foreign investments in industrialized nations such as the United Kingdom and New Zealand. More recently, non-Japanese Asian banks have also invested and expanded their presence in Asian countries. Examples include the acquisition of majority stakes in Thai Danu and Radanashin Bank in Thailand by two Singapore banks; the expansion of a Malaysian bank in Singapore; and the expansion of Hong Kong and Singapore banks in China.

While studies on the lending behaviors of Japanese banks in the region are rather scarce, preliminary analysis suggests that the bulk of the lending was channeled to Japanese enterprises, which were investing heavily in the region. As early as 1995, the flow of Japanese bank lending to the region slowed, and the crisis appears to have accelerated the decline in Japanese banks' lending in Asian countries, especially towards non-Japanese borrowers.

The reduction was partly motivated by a reassessment of available opportunities in the region, and partly to meet capital requirements, with Japanese banks opting to do so by reducing their exposure to riskier loan assets. Japan remains a major lending country to Asia, but the proportion of lending by UK and US banks has risen.